No. 13,804

IN THE

United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
EDWARD D. SULTAN,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
OLGA L. SULTAN,
Respondent.

On Petitions for Review of the Decisions of the Tax Court of the United States.

BRIEF FOR RESPONDENTS.

MILTON CADES,
Bishop Trust Building, Honolulu, Hawaii.
Attorney for Respondents.

SMITH, WILD, BEEBE & CADES,
Bishop Trust Building, Honolulu, Hawaii,
Of Counsel.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO, CALIFORNIA

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BRIEF FOR RESPONDENTS.

OPINION BELOW.

The opinion of the Tax Court (R. 159-178) is reported at 18 TC 715.

JURISDICTION.

The petitions for review in these cases involve deficiencies aggregating $406,452.34 in the federal income taxes of the taxpayer Edward D. Sultan (herein called the "Taxpayer") and his wife[1] for the years 1944 through 1946 (R. 5, 26, 179-91). On April 26, 1949,[2] the Commissioner of Internal Revenue (herein called the "Commissioner") mailed to the Taxpayer and his wife notices of deficiencies in their income taxes for the years in question (R. 14, 34). Within 150 days thereafter, on August 12, 1949, the Taxpayer and his wife, pursuant to Section 272 of the Internal Revenue Code, filed petitions with the Tax Court for redetermination of such deficiencies (R. 4-24, 26-37). The proceedings were consolidated for hearing in the court below (R. 2, 4). On October 31, 1952, decisions of the Tax Court were entered redetermining the deficiencies (R. 179, 180). On January 10 and 19, 1953, the Commissioner filed his petitions for review invoking the jurisdiction of this court under Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948 (R. 181-87).

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[1]The Taxpayer's wife is involved only because of the community property law of Hawaii which became effective on June 1, 1945 (R. 160).

[2]There were added to the gross income of the Taxpayer and his wife for each of the years in question amounts in excess of 25 percent of the gross income stated in their returns (R. 16, 19, 22, 35). Accordingly, under Section 275(c), Internal Revenue Code, assessment and collection of the deficiencies were not barred by the statute of limitations.

QUESTIONS PRESENTED.

1. Whether on all of the evidence in the record the Tax Court's finding of fact, that Edward D. Sultan, Ernest W. Sultan, Marie Hilda Cohen, Gabriel L. Sultan and Edward D. Sultan Trust really and truly intended to join together for the purpose of carrying on the business of Edward D. Sultan Co. and sharing in its profits and losses, is so unreasonable as to require a reversal of the decision below.

2. Whether the Tax Court erred in holding that in creating the Edward D. Sultan Trust, the Taxpayer did not retain sufficient interest in or control over the corpus or income thereof to render himself liable for income taxes or the income thereof.

STATUTES AND REGULATIONS INVOLVED.

The pertinent statutes and regulations are set forth in the Appendix, *infra.*

STATEMENT.

The Taxpayer does not controvert the Commissioner's statement of the case in the Brief for the Petitioner (herein cited "Brief") (pp. 3-13).

SUMMARY OF ARGUMENT.

The Commissioner does not here challenge the validity of the Edward D. Sultan Trust or of the special partnership agreement, under the law of the Territory of Hawaii, nor does he question the binding obligation thereof. Thus, the question is whether the special partnership should be recognized and given effect under the revenue laws of the United States. The test for determining that question has been formulated by the Supreme Court in *Commissioner v. Culbertson,* 337 U.S. 733, 93 L.ed 1659 (1949), and whether any given partnership measures up to that test is a question of fact. *Commissioner v. Culbertson,* 337 U.S. 733, 741-42, 93 L.ed 1659, 1664-65. A finding of fact by the Tax Court will not be disturbed on appeal unless it is clearly unreasonable. *Boehm v. Commissioner of Int. Rev.,* 326 U.S. 287, 293-94, 90 L.ed 78, 84-85 (1945); *Commissioner of Int. Rev. v. Scottish Am. Inv. Co.,* 323 U.S. 119, 123-24, 89 L.ed 113, 116-17 (1944); *Helvering v. Kehoe,* 309 U.S. 277, 279, 84 L.ed 751, 753 (1940). An examination of the record in the case at bar reveals not merely substantial basis for the Tax Court's finding on this question, but clear and persuasive evidence virtually compelling the conclusion at which the Tax Court arrived.

The income of a private express inter-vivos trust, although not payable to the settlor thereof, may be taxed to settlor under the revenue laws of the United States if the settlor retains a sufficient "bundle of rights" in the trust (*Helvering v. Clifford,* 309 U.S.

331, 84 L.ed 788 (1940)), as where a settlor creates a short term trust naming himself as trustee, grants himself broad discretion as to the income to be distributed, and retains a reversionary interest in the corpus of the trust. In the case at bar, however, the Taxpayer made an absolute irrevocable transfer in trust to independent trustees, had no control over the income of the trust, and possessed no reversion in the corpus thereof. Even under the special partnership agreement the Taxpayer had no control over the corpus or income of the trust which he could lawfully exercise for his own benefit. The doctrine of *Helvering v. Clifford, supra,* is clearly inapplicable to the instant case.

The Commissioner in his argument (Brief 13-15) reads into the opinion of this court in *Toor v. Westover,* 200 F.2d 713 (9th Cir. 1952), a departure from the test laid down by the Supreme Court in *Commissioner v. Culbertson, supra,* and seeks to establish a rule of law making the issue in family partnership cases one to be determined by the very kind of "objective tests" so clearly repudiated by the Supreme Court in *Commissioner v. Culbertson.*

ARGUMENT.

I.

THE EVIDENCE APPEARING IN THE RECORD CLEARLY SUPPORTS THE TAX COURT'S FINDING OF FACT THAT THE TAXPAYER, ERNEST W. SULTAN, MARIE HILDA COHEN, GABRIEL L. SULTAN AND THE EDWARD D. SULTAN TRUST REALLY AND TRULY INTENDED TO JOIN TOGETHER FOR THE PURPOSE OF CARRYING ON THE BUSINESS OF EDWARD D. SULTAN CO. AND SHARING IN ITS PROFITS AND LOSSES.

The Commissioner does not here challenge the validity of the Edward D. Sultan Trust or of the special partnership agreement under the law of the Territory of Hawaii, nor does he question the binding obligation thereof. Thus, the question is whether the special partnership should be recognized and given effect under the revenue laws of the United States. The test for determining that question has been formulated by the Supreme Court in *Commissioner v. Culbertson, supra,* in the following language:

> ". . . whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. . . ." (337 U.S. 733, 742-43)

> ". . . If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. . . ." (id. at 747)

A review of the record reveals ample support in the evidence for the Tax Court's finding on the question as posed in the *Culbertson* case.

A. *The Agreement.* The terms of the special partnership agreement (R. 71-90) clearly reflect the intent of the parties to join as partners in the enterprise. The first (unnumbered) paragraph of the agreement (R. 71-73) recites that the parties "do hereby form with each other a special partnership for the purpose of acquiring and thereafter conducting the business heretofore carried on by Edward D. Sultan . . . and for other purposes . . . ." which purposes are spelled out in detail in paragraph 1 (R. 71-73).

Paragraph 3 of the agreement (R. 73-75) sets forth the respective capital contributions of the partners and secures to the special partner all of the powers, rights and duties of special partners as prescribed by Chapter 225 of the Revised Laws of Hawaii 1935 (see Appendix, *infra*) as the same might from time to time be amended. The same paragraph provides that the special partner shall not be liable for the debts of the partnership beyond the limits set by Section 6887 of the Revised Laws of Hawaii 1935 (see Appendix, *infra*) as the same might from time to time be amended.

Paragraph 4 of the agreement, both as originally adopted and as amended, provides for compensation for services rendered to the partnership by the general partners actively engaged in the business of the partnership, and provides that such compensation shall be chargeable as an expense of the business for the purposes of computing the net profits of the partnership (R. 75, 111). The same paragraph provides for annual division of the net profits of the partnership in direct proportion to the stated capital interest of each of the partners and permits any partner to withdraw such portion of his profits as the general partners may from time to time deem advisable (R. 75, 111). It also provides that any profits not so withdrawn shall be credited to advance accounts in the names of the respective partners for whom such profits are being held, which accounts shall bear interest at the rate of five percent per annum computed on quarterly balances (R. 75, 76, 111, 112).

Paragraph 7 of the agreement expressly recognizes the right of the special partner to investigate the partnership affairs and advise the general partners as to its management at all times (R. 77).

Paragraph 9 of the agreement requires that proper partnership books of account be kept, and expressly confers upon each partner the right at all times to have full and free access to and to make copies of the partnership books (R. 78-79).

Paragraph 10 of the agreement requires annual general accounts to be taken of all of the assets and liabilities and dealings and transactions of the partnership and expressly requires that copies of such accounts be sent to each partner (R. 79-80).

Paragraph 8 of the agreement provides that if any partner were to make any additional capital contribution to the partnership, every other partner would have the right to make like contributions in order to keep the interest of each partner in the partnership in proportions equal to those in existence at the date of its inception (R. 78).

Although pursuant to paragraph 8 no general partner could assign or mortgage his or her share of or interest in the partnership or its assets or profits (except to another partner), the special partner was free to assign its interest in the partnership with the consent of the general partners (ibid.).

Paragraph 11 of the agreement (R. 80-81) provides that upon the determination of the partnership from whatever cause, the assets of the partnership remaining after payment of its debts and expenses shall be applied first to the payment of the balance due to the special partner as shown on its advance account (before being applied to the payment of the balance due any general partner as shown in his or her advance account), and then in payment of the special partner's share of the capital (before being applied in payment of the share of capital of any general partner).

B. *The Conduct of the Parties.* The evidence in the record concerning the conduct of the parties in pursuance of the partnership agreement clearly reflects the intent of those parties to join together for the purpose of carrying on the enterprise and sharing in its profits and losses.

Taxpayer and his brother, Ernest W. Sultan, both general partners, rendered services to the partnership in accordance with paragraph 5 of the partnership agreement (R. 203-04, 225-26). For these services Taxpayer and Ernest W. Sultan were paid reasonable compensation, to which all of the partners appear to have consented, and such compensation was deducted as an expense of the partnership business in computing the profits thereof (R. 204-06, 209, 233, 238-39).

The general partners consulted together and discussed the business policies among themselves very extensively (R. 232). The special partner investigated the partnership affairs and advised the general partners as to its management in accordance with the partnership agreement and with the applicable law. In this connection the Taxpayer's uncontradicted testimony, fully corroborated by that of the trust officer in charge of the Edward D. Sultan Trust (*infra,* pp. 11-12) shows that the Taxpayer consulted regularly with the special partner, furnished it regular accounts of the conduct of the business, and gave interim accounts of the status of the business (R. 214-15). The special partner was advised with respect to changes in salary for the Taxpayer and for Ernest W. Sultan, and expressed its agreement thereto (R. 233).

The testimony of the trust officer who succeeded to the responsibility for the Edward D. Sultan Trust account shows that the special partner consulted with the Taxpayer as to how the business was going, as to the difficulty of obtaining shipments due to the war, and as to the growth of the business (R. 252-53). That testimony further shows active consultation and advice by the special partner with respect to the sale of its partnership interest by the special partner (R. 254-55); discussions of the business between the special partner and the Taxpayer periodically three or four or five times a year; and participation in discussions concerning the adoption of various and sundry policies by the partnership (R. 257-58). Audit reports and oral reports were furnished to the special partner regularly and promptly (R. 215).

With the exception of certain periods when with the consent and agreement of the special partner certain partnership profits were retained in the business to permit the accumulation of additional capital, the special partner was adamant in its insistence upon full and prompt distribution of its distributive share of the partnership profit (R. 49, 156, 211, 228, 254-55, 259-61).

When the special partnership was dissolved through the purchase by the Taxpayer of the interests of the other partners, the purchase price of those respective interests followed exactly the percentage allocation of capital as determined by the partnership agreement (R. 47, 48, 137-54, 210-12, 239-40).

The parties to the special partnership agreement, including the Edward D. Sultan Trust, held themselves out to the public as general and special partners respectively by filing in the Office of the Treasurer of the Territory of Hawaii a duly executed certificate of special partnership and affidavits of each of the partners, and by publishing a statement of substance of certificate of special partnership in the Honolulu Advertiser on four different days (R. 45, 94-105). In addition, upon its termination the respective members of the special partnership gave public notice of the dissolution of the special partnership and the termination of their partnership relationship by filing a statement thereof in the Office of the Treasurer of the Territory and by publishing notice of dissolution in the Honolulu Advertiser on four different days (R. 48, 49, 149-54).

Each of the general partners other than the Taxpayer became a member of the special partnership by reason of his or her particular qualifications and contribution to the business (R. 44, 71-90, 199-201), and it is significant that the Commissioner does not assert that they were not bona fide members of the special partnership.

C. *The Relationship of the Parties.* The evidence in the record with respect to the relationship of the parties lends ample support to the Tax Court's finding. Each of the Taxpayer's brothers and sister who joined as a general partner in the conduct of the partnership business had been associated in the wholesale jewelry business in one aspect thereof or another. Ernest W. Sultan had been manager of the Taxpayer's sole proprietorship in the past (R. 194-95), Marie Hilda Cohen had aided by furnishing warehousing space on the west coast (R. 200), and Gabriel L. Sultan had acted as a sales representative on the mainland (R. 200-01). The trustees of the Edward D. Sultan Trust (of which the Taxpayer's son was the beneficiary) maintained at all times a relationship of independent arm's length dealing with the general partners. The corporate trustee exercised its independent judgment in deciding whether to become a special partner, even insisting upon approval by court of competent jurisdiction before it would accept the trusteeship (R. 252). It insisted upon prompt and full withdrawals of its partnership earnings (R. 211, 228, 254-55, 259-61) and exercised its independent judgment on partnership affairs (R. 254-55, 264) including the sale of its partnership interest (R. 264).

D. *Abilities and Contributions of the Parties.* An examination of the evidence in the record relating to the respective abilities and contributions of the parties indicates ample support for the Tax Court's finding. The Taxpayer had been in the jewelry business or in the manufacturing jewelry business practically all of his life since he was ten years old (R. 194), and he contributed both capital (R. 74, 91-94) and services (R. 203-04, 225-26) to the partnership enterprise.

General partner Ernest W. Sultan had had considerable experience as office manager of the sole proprietorship and had knowledge of the jewelry business far above that of the Taxpayer (R. 221-22). He contributed both capital (R. 74, 91-94) and services (R. 225-26) to the partnership enterprise.

General partner Marie Hilda Cohen was a capable business woman and ran a business in San Francisco with her husband (R. 199-200, 218). She contributed both capital (R. 74, 91-94) and warehousing services to the partnership enterprise.

General partner Gabriel L. Sultan was an experienced jewelry salesman, having previously acted as mainland salesman for the sole proprietorship (R. 200-01, 218-20). He contributed capital to the partnership enterprises (R. 74, 91-94) and was only prevented from furnishing services by circumstances arising out of World War II and beyond the control of any of the partners (R. 218-20).

Bishop Trust Company, Limited, conducted a trust company business in the Territory of Hawaii and had enjoyed wide experience in operating business enterprises in a fiduciary capacity. Among the varieties of businesses operated by Bishop Trust Company, Limited, were included a structural steel business, a department store, a tile business, dairies, ranches, an ice cream business, a soda and ice works which held the Coca-Cola franchise for one of the Hawaiian Islands, and an auto sales agency (R. 248-51). As co-trustee with Ernest W. Sultan, it contributed capital to the partnership enterprise (R. 74, 91-94) and contributed advice and consultation to the full extent permitted by law on the part of a special partner (R. 214, 233, 252-53, 254-55, 257).

Capital was a significant income producing requirement of the partnership business. The partnership paid all invoices immediately upon shipment of the goods covered even though the goods were not received until much later (R. 207-09), and indeed the general partners left their earnings in the special partnership in order to assure that sufficient capital would be available to make such payments (R. 209). The Taxpayer made continual loans of large sums to the partnership business without interest in order to build up the capital funds (R. 211). As the testimony of one of the trust officers in charge of the Edward D. Sultan Trust indicates, the special partner was aware of the need for substantial capital in the business and gave its careful attention to the problem (R. 252-53, 254-55, 263-64), temporarily permitting its partnership profits to be retained in order to improve the credit rating of the special partnership (ibid.).

E. *Actual Control of Income.* The evidence in the record with respect to the exercise of actual control over the special partnership income fully supports the Tax Court's finding that the parties thereto really and truly intended to join as partners in the conduct of the special partnership business. As shown above (p. 12), the special partner firmly insisted upon withdrawing, and promptly withdrew, the entire amount of its distributive share of the special partnership net profits. When it was desired to retain some of the partnership profits, the consent of the special partner was first obtained (R. 263-64). During the entire period of the existence of the special partnership, the special partner received and held under its sole and exclusive dominion and control its entire distributive share of the special partnership income and none thereof was ever paid to the Taxpayer or used in discharge of his obligations to support his wife or his child (R. 155, 263-64, 215).

F. *Business Purpose.* The purpose of preserving and continuing a going business as a family enterprise for the members of a family is a proper, legitimate and indeed a commendable business purpose. *Ardolina v. Commissioner of Internal Revenue,* 186 F.2d 176 (3d Cir. 1951); *Nicholas v. Davis,* 204 F. 2d 200 (10th Cir. 1953). The uncontradicted testimony of the Taxpayer clearly indicates that the special partnership was entered into for the purpose of assuring the continuity of the business and of interesting the Taxpayer's son in the business in order that it might have the benefit of his subsequent participation, as well as to assure the availability of necessary warehousing space and sales representation on the mainland of the United States (R. 195-201, 217-20). That testimony further clearly indicates the absence of any motive of tax avoidance or desire to reallocate income within the family group (R. 198, 230-32).

G. *Dominion and Control of Special Partner's Interest.* The Edward D. Sultan Trust was the donee of property in the amount of $42,000.00, as is shown by the Commissioner's determination that the Taxpayer made a completed absolute gift to the trust upon its creation in 1941, the Commissioner's determination that the value of the gift was greater than $42,000.00, and his assessment of a deficiency in gift tax on that account (R. 45-46), and as is more fully demonstrated under Point II, *infra*, which discussion is herein incorporated. And the Edward D. Sultan Trust invested the property given to it in the special partnership (R. 51-62, 63-70, 71-90, 91-94).

The trust, as donee of the property which it had invested in the special partnership as a special partner, was clothed with all of the dominion and control permissible in a special partner under the law of the Territory of Hawaii (R. 73-75) and by its exercise of such dominion and control, it influenced the conduct of the partnership to the full extent that a special partner lawfully could do so (R. 214, 233, 252-53, 254-55, 257). It did not merely influence the disposition or special partnership income, but insisted upon full and prompt payment of all of the distributive share of special partnership income allocable to it under the terms of the special partnership agreement (R. 49, 156, 211, 228, 254-55, 259-61). The record clearly indicates that the special partner enjoyed the "fruits of the partnership" to the very fullest.

From the foregoing review of the evidence appearing of record in the case at bar, it is obvious that there is more than sufficient support for the Tax Court's finding of fact that the Taxpayer, Ernest W. Sultan, Marie Hilda Cohen, Gabriel L. Sultan and the Edward D. Sultan Trust really and truly intended to join together for the purpose of carrying on the business of Edward D. Sultan Co. and sharing in its profits and losses.

II.

THE INCOME OF THE TRUST IS NOT TAXABLE TO THE TAXPAYER UNDER THE DOCTRINE OF HELVERING v. CLIFFORD OR THE COMMISSIONER'S REGULATIONS RELATING THERETO.

In *Helvering v. Clifford,* 309 U.S. 331, 84 L.ed 788 (1940), settlor created a trust for a term of five years with the proviso that it would terminate earlier on the death of either settlor or his wife with himself as trustee and his wife as income beneficiary. On the termination of the trust the entire corpus was to revert to the settlor while accrued or undistributed net income and net proceeds from the investment of any such net income was to be treated as his wife's absolute property. During the continuance of the trust settlor was to pay over such part of the income therefrom as he in his absolute discretion might determine, and during that period he had full power to exercise all voting rights incident to the trusteed shares of stock, to sell, encumber or otherwise dispose of any part of the corpus or income on such terms as he in his absolute discretion deemed fitting, and to invest any of the property of the trust by loans, secured or unsecured, by deposits in banks, or otherwise, without restriction as to the speculative character or rate of return of any such investment, or of any laws pertaining to the investment of trust funds. The Supreme Court, holding the settlor taxable on the income of the trust, in addition to the family relationship of the settlor and the beneficiary, emphasized the following factors: The short term of the trust, the fact that settlor was also the trustee, the absolute discretion in the settlor-trustee as to income to be distributed, and the reversion to the settlor upon the termination of the trust.

Underlying the decision of the Supreme Court in the *Clifford* case is the principle that where a purported donor retains controls over the subject matter of his gift, exercisable for his own personal benefit, sufficient to afford him the economic use and benefit of the property to substantially the same extent as if he were the absolute owner thereof, then the donor should remain taxable upon the income of that property.

An examination of the trust deed in the case at bar shows that with the exception of the close family relationship between settlor and beneficiary, none of the factors considered in the *Clifford* case is present here.

The term of the trust is to continue until the Taxpayer's son, who was between thirteen and fourteen years of age at the inception of the trust (R. 43, 51, 52), reaches the age of thirty years or sooner dies (R. 53-54). Thus, the maximum term of the trust was just over sixteen years.

The Taxpayer in the case at bar did not name himself a trustee of the Edward D. Sultan Trust. Instead, he carefully selected his brother, Ernest W. Sultan, and Bishop Trust Company, Limited, as trustees in order to take advantage of their experience and knowledge (R. 51, 196-99). Moreover, he named his sister, Marie Hilda Cohen, successor trustee to Ernest W. Sultan, and provided that in the event both Ernest W. Sultan and Marie Hilda Cohen should be or become unable to act or decline to act or resign as trustee, then Bishop Trust Company, Limited, should act as sole trustee (R. 59).

Any suggestion that Taxpayer's brother in his capacity as co-trustee would be or was under the domination of the Taxpayer loses its force by reason of the fact that under the trust deed and the applicable law, the concurrence of both trustees would be required on all decisions. 2 *Scott, Trusts,* Sec. 194 (1939).

Since the Taxpayer was not a trustee of the Edward D. Sultan Trust, it is self-evident that he could not under the trust deed control the distribution or other disposition of the income therefrom.

The Taxpayer held no reversionary interest whatever in the corpus or income of the Edward D. Sultan Trust. Upon the termination of the trust, the trust property was to be distributed in the manner set out in the trust deed (R. 53-54) to the Taxpayer's son or, if he were not then living, to the Taxpayer's wife or, if she were not then living or in certain other circumstances, to the named brothers and sister of the settlor, or, if any of them were not living, to his or her issue.

Thus, it is evident that none of the factors emphasized by the Supreme Court in the *Clifford* case and repeatedly re-emphasized by the lower courts is present in this case.

Treasury Regulations 111, Section 29.22(a)-21[3] (herein called the "Clifford Regulations"), embody the Commissioner's exegesis upon the doctrine of *Helvering v. Clifford, supra,* and is applicable only to taxable years beginning on and after January 1, 1946. The Commissioner in his argument (Brief 23, n. 9) suggests in passing that the 1946 income of the trust might be taxable to the Taxpayer under either or both of Sections 29.22(a)-21(e)(2) and 29.22(a)-21(e)(4). Section 29.22(a)-21(e)(2) asserts the Commissioner's

[3]TD 5488, 1946-1, Cum. Bull. 19;
TD 5567, 1947-2, Cum. Bull. 9.

opinion that income of a trust, whatever its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant upon its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust through a power exercisable by the grantor or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor to borrow the corpus or income directly or indirectly without adequate interest in any case or without adequate security except where a trustee (other than the grantor or spouse living with the grantor) is authorized under a general lending power to make loans without security to the grantor and other persons and corporations upon the same terms and conditions. Section 29.22(a)-21(e)(4) states the Commissioner's similar opinion with respect to a power exercisable by the grantor in a non-fiduciary capacity to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments.

The Commissioner suggests here that the terms of the trust permitting the trustees to make loans to the partnership without liability for any resulting losses (R. 56) and providing that during the lifetime of the Taxpayer the trustees shall obtain the consent of the Taxpayer to the making of investments other than investments which trustees are permitted by law to make, render the 1946 income of the trust taxable to the Taxpayer by the force of the Clifford Regulations. The Commissioner's error in this respect arises largely from the fact that, assuming as his major premise the result for which he contends, namely, that the special partnership, Edward D. Sultan Co., was a mere sham not entitled to recognition for income tax purposes, the Commissioner reasons that the Taxpayer and the partnership were one and the same entity for all purposes.

Without conceding the validity of the Clifford Regulations, the Taxpayer contends that those regulations are inapplicable in the case at bar. The trustees' power to make loans to the partnership of Edward D. Sultan Co. is a far different thing from a power to make loans to the Taxpayer. Any such loan would be to the partnership and for the partnership's account and not to the Taxpayer personally or for his personal benefit. As a partner in Edward D. Sultan Co., the Taxpayer stood in a fiduciary relation to each of the other partners, including the special partner. The Supreme Court of the Territory of Hawaii has recently reaffirmed in the strongest terms the proposition that there is scarcely any relation in life which calls for more absolute good faith than the relationship of partners, and that the obligation is even greater in the case of a managing partner. *Watumull v. Ettinger,* Sup. Ct., T. H., Jan. 3, 1952; see also *Toor v. Westover,* 200 F. 2d 713, 715 (9th Cir. 1952).

Assuming that a loan had been made from the trust to the partnership (and the record reveals no such loan), the Taxpayer could only have diverted the proceeds of the loan to his personal use and benefit by a violation of his clear and unambiguous duty as a partner, which violation would give rise to a cause of action in favor of the trust and all other partners not participating therein against the Taxpayer. *Watumull v. Ettinger, supra.* The proposition that the naked power to seize property in violation of law renders the holder of that power taxable on the income of that property has never been seriously advanced.

In his argument from the requirement of consent to non-legal investments by the Taxpayer, the Commissioner overlooks the fact that the very terms of the Clifford Regulations restrict their applicability to a power exercisable *in a non-fiduciary capacity.* Under the doctrine of the *Clifford* case, a mere power to direct or veto proposed investments not exercisable for the benefit of the grantor does not render the holder of the power taxable on the income of the trust property.

In *Cushman v. Commissioner of Internal Revenue,* 153 F.2d 510 (2d Cir. 1946), petitioner created an irrevocable trust for the benefit of his children, naming himself and his wife as co-trustees with a corporate successor trustee. The petitioner reserved to himself, as grantor, the power to control retention or sale of trust property and to direct investment or reinvestment of trust funds. The Commissioner determined that the trust income was taxable to the petitioner under the doctrine of the *Clifford* case, and the Tax Court agreed. On appeal to the Court of Appeals for the Second Circuit, the decision of the Tax Court was reversed. In answer to the Commissioner's contention, the court held that the petitioner's reserved power to control retention or sale of trust property and to direct investment and reinvestment of trust funds did not suffice to bring the case within the doctrine of *Helvering v. Clifford,* since the powers so retained could not be used contrary to the best interests of the beneficiary of the trust. Judge Chase, writing for the court, pointed out that ordinarily such powers are held in a fiduciary capacity and their exercise is subject to the scrutiny of the courts.

Again, in *Kohnstamm v. Pedrick,* 153 F.2d 506 (2d Cir. 1945), an appeal from a judgment dismissing the complaint entered after trial upon stipulated facts in the District Court for the Southern District of New York, plaintiff had created a trust for the benefit of his wife and children and had reserved to himelf, as grantor, the power, among others, to direct the sale of any part of the trust fund and substitute equivalent investment and to vote all shares of stock held by the trust. Judge Learned Hand, writing for the court, in reversing the decision below, held that the power to direct the sale of trust assets and substitute equivalent instruments, even when coupled with the other powers reserved, did not bring the plaintiff within *Helvering v. Clifford* and make him the owner of the trust property for tax purposes. See also *William P. Anderson,* 8 TC 921 (1947), acq. 1947-2 Cum. Bull. 1; *Arthur L. Blakeslee,* 7 TC 1171 (1946), acq. 1947-1 Cum. Bull. 1; *David L. Loew,* 7 TC 363 (1946); *Ernst Huber,* 6 TC 219 (1946), acq. 1946-1 Cum. Bull. 3.

The very terms of the trust deed in the case at bar (R. 55-56) negative any inference that the power reserved by the Taxpayer to require his consent to the making of certain investments during his lifetime is reserved for the benefit of anyone other than the beneficiary of the trust. The trust deed confers upon the trustees power to invest in property, real or personal, insofar as in their judgment they shall deem such investments advisable, and recites that in making such investments, the trustees shall not be restricted to investments which are legal for trust funds. The proviso reserving the power to require the Taxpayer's consent follows immediately after this grant and clearly relates to the making of investments which are not legal for trust funds. In every instance during the life of the Taxpayer, proposed investments must be investments which, in the judgment of the trustees, are advisable for the trust—that is, investments which are in the best interests of the income beneficiary and remainderman under the trust.

Thus, even if the Clifford Regulations are valid and applicable, the Taxpayer is not taxable upon the trust income by the force of those regulations.

If the Clifford Regulations are applicable, a determination that the 1946 income of the trust is taxable to the Taxpayer by the force of the regulations must result in the conclusion that the regulations as applied are invalid. As has been demonstrated above, the Taxpayer is not taxable upon the income of the trust under the doctrine of *Helvering v. Clifford* alone. If the Taxpayer is held taxable on the 1946 income of the trust without any change in the facts or in the applicable law, then the regulations are invalid for the reasons stated in *Commissioner of Internal Revenue v. Clark,* 202 F.2d 94 (7th Cir. 1953). In that case the taxpayers created irrevocable trusts for the term of five years, subject to extension by the grantors. Thereafter and for good cause, the grantors extended the irrevocable term of the trusts for at least five additional years, all other provisions remaining unchanged. The Commissioner assessed the 1946 income of the trusts to the grantors on the theory that the terms of the trusts were of less than ten years' duration and hence the income thereof was taxable to the grantors under the Clifford Regulations. The Tax Court held that the 1946 income of the trusts was not taxable to the grantors under Section 22(a) of the Internal Revenue Code or under *Helvering v. Clifford, supra,* or under the Clifford Regulations. On appeal by the Commissioner the Court of Appeals for the Seventh Circuit, affirming the decision of the Tax Court, held that the Clifford Regulations as applied in that case were unreasonable and arbitrary and therefore void. Chief Judge Major, for the court, pointed out that the regulation created a conclusive or irrebuttable presumption and thus stated a rule of substantive law. Hence, without any alteration in the trust indentures and without any change in the relation of any of the parties thereto, that which was not income taxable to the grantors in 1944 and 1945 became income taxable to the grantors in 1946 solely as a result of the promulgation of the Clifford Regulations. Referring to cases in which the Supreme Court struck down as violative of due process a state statute which provided, in effect, that gifts of a decedent's estate made within six years of his death were made in contemplation thereof[4] and a congressional enactment which created a conclusive presumption that gifts made within two years prior to the death of the donor were made in contemplation of death,[5] Chief Judge Major stated that it appears that even Congress would be without power to create the conclusive presumption which the Treasury had attempted to create in the Clifford Regulations, and that it was even more certain that an administrative agency is without authority to promulgate such a regulation.

Exactly the same situation would exist in the case at bar if the trust income were taxed to the Taxpayer by the force of the Clifford Regulations. There was no significant change in the provisions of the trust deed between the years preceding and the year 1946. The Clifford Regulations create a conclusive or irrebuttable presumption, a rule of substantive law, effec-

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[4]*Schlesinger v. Wisconsin,* 270 U.S. 230, 70 L.ed 557 (1926).
[5]*Heiner v. Donnan,* 285 U.S. 312, 76 L.ed 772 (1932).

tive on and after January 1, 1946, that the existence of a power in the grantor to borrow corpus or income or of a power in a non-fiduciary capacity to veto proposed investments makes the income of a trust the income of the grantor thereof. For the reasons set forth in *Commissioner of Internal Revenue v. Clark, supra,* any such application of the Clifford Regulations to the case at bar would be arbitrary, unreasonable and void.

Thus, the terms of the trust and the circumstances of its creation demonstrate that the income thereof is not taxable to the Taxpayer under the doctrine of *Helvering v. Clifford* or the extension of that doctrine embodied in the Clifford Regulations.

A consideration of the terms of the trust and the circumstances of its creation together with the terms of the special partnership agreement and the operations of the special partnership leads to a like conclusion. The term of the special partnership agreement was initially from August 30, 1941, to April 30, 1943, and thereafter from year to year unless terminated (R. 71, 87). As amended January 12, 1942, the special partnership agreement provided that after the death of the Taxpayer, the agreement should continue in full force and effect until the end of the fiscal year of the business of the partnership ending in 1953 (R. 107). As amended February 2, 1945, the agreement provided that the term of the partnership should be for a period commencing February 2, 1945, and ending January 31, 1946, and thereafter from year to year until terminated (R. 121). The term of the special partnership agreement, however, had no effect upon the term of the trust, and on termination of the partnership agreement, the Taxpayer could not receive any part of the special partner's share of capital or of earnings. Indeed, the special partner was granted priority in distribution on termination (R. 80-81).

The Taxpayer was the general partner with the majority interest in the special partnership, but, as pointed out above (pp. 20-26), his powers as such were not and could not lawfully be exercised for his own personal benefit. Under the rule laid down by the Supreme Court of the Territory of Hawaii in *Watumull v. Ettinger, supra,* the Taxpayer owed a duty of absolute good faith to his partners, including the special partner. See also *Toor v. Westover, supra.* Nor could the Taxpayer, as general partner with the majority interest in the special partnership, cause the assets of the special partnership to be diverted to any personal business of the Taxpayer. True, the special partnership agreement permitted the partnership to enter into a broad field of activity, but any business carried on by the partnership would be for the benefit and account of the partnership and of each of the partners therein.

Under the special partnership agreement, the Taxpayer had no power over the income of the partnership exercisable for his own benefit. While he held the power to determine the compensation of the general partners actively engaged in the business of the partnership, including himself (R. 75), by the very terms of the grant of that power, the compensation for services was restricted to "the reasonable value of the services rendered to the partnership" (ibid.). Had the Taxpayer attempted to cause himself to be paid an unreasonably large salary for his services to the partnership (and there is no evidence in the record of any such attempt), he would have violated his absolute duty of good faith to the partners including the special partner, and would have been held to account under the rule of *Watumull v. Ettinger, supra.*

Similarly, partners' withdrawals from the partnership of the profits attributable to their interests was subject to the control of the Taxpayer as general partner with the majority interest in the partnership. Here again, any retention of partnership earnings (and the record indicates that none of the special partner's earnings were retained without its consent) would inure to the benefit of the partnership and all of the partners therein, and any attempt on the part of the Taxpayer (and the record indicates no such attempt) to withhold the earnings of the special partner or of any other partner for his own personal use or benefit would constitute a violation of the rule laid down in *Watumull v. Ettinger, supra,* and render the Taxpayer accountable therefor. To contend that the existence of this power renders the Taxpayer taxable on the special partner's distributive share of the partnership income is once again to assert that the naked power to seize property in violation of law makes the holder of that power liable for taxes on the income of the property.

Nor could the Taxpayer obtain control of the corpus of the trust for his own use or benefit. The Commissioner in his argument states that the Taxpayer "could at any time buy out any of the others at book value plus their share of undistributed profits" (Brief 22). This statement is without foundation in the record and is contrary to the fact. The Taxpayer, as the general partner with the majority interest in the partnership, could terminate the special partnership at any time upon certain written notice (R. 80). In the event of such termination, however, the assets of the special partnership, after payment of its debts and expenses, were to be distributed to the partners in the proportion to their capital contributions, and the special partner was afforded priority in this distribution (R. 80-81). If any other general partner were to die or give notice of termination during the term of the special partnership agreement, then and only then the Taxpayer could purchase the interest of the deceased general partner at the fair value thereof (R. 83-84, 118-20). The Taxpayer, as general partner with the majority interest in the special partnership, could use the assets of the partnership in the partnership business and share in the profits and losses thereof, but he could not, without violating his duty of absolute good faith to his other partners divert those assets to his own personal business or to any other business. *Watumull v. Ettinger, supra.* Similarly, the option granted to the Taxpayer's representative to succeed to or carry on the interest of the Taxpayer in the business in the event of the Taxpayer's death, either as a general partner or as a special partner, would afford to the Taxpayer's estate no power to divert the partnership assets to the benefit of the estate, and all of the acts of the Taxpayer's representative upon succession to the Taxpayer's interest in the partnership would be governed by the same duty of absolute good faith which governed the Taxpayer during his lifetime.

Thus it is clear that under the doctrine of the *Clifford* case, the trust deed and special partnership agreement taken together with the circumstances surrounding the same did not reserve to the Taxpayer any power sufficient to render him taxable upon the income of the trust or the special partner's distributive share of the partnership income.

It is clear from the Commissioner's argument (Brief 15-25) that he asserts the income in question to be taxable to the Taxpayer solely under the doctrine of *Helvering v. Clifford, supra,* and relies almost exclusively upon the language of the opinion of this court in *Toor v. Westover, supra.* The Commissioner's only challenge to the bona fides of the special partnership is based on his assertion that the trustees did not become the real owners of the trust property (Brief 23), and if this contention fails, his entire argument falls.

The Commissioner maintains that the trustees "did not acquire the usual attributes of ownership with respect to this property" (Brief 21), and lists twelve propositions in support of this contention. That these twelve propositions, to the limited extent that they have a basis in the law or the record, do not lead to the conclusion contended for, appears from the following seriatim examination thereof:

1. ". . . They were required to invest it in the partnership. . . ." (Brief 21) The Commissioner's position here appears to be that a transfer of property in trust wherein the trustee is not granted the power of sale, but is directed to retain the property so transferred, cannot so shift the ownership of the property as to render the trustee or the trust beneficiaries taxable upon the income thereof. On this theory a transfer or gift of a partnership interest would never be effective to shift the incidence of taxation, since the donee would have no choice but to become a partner or refuse the gift. Simply to assert these propositions is to accomplish their refutation.

2. ". . . as a limited partner, they had no voice in the use of their investment. . . ." (Brief 21) This statement simply is not borne out by the law, the special partnership agreement or the record. As pointed out above, the trustees were granted all of the voice in the use of their investment that it was possible to grant to a special partner under the law of the Territory of Hawaii, and they exercised their rights to the fullest. There is no doubt that a special

or limited partner may be recognized under the revenue laws of the United States as a bona fide partner in a special or limited partnership. *Nicholas v. Davis,* 204 F.2d 200 (10th Cir. 1953); *Toor v. Westover, supra; John A. Morris,* 13 TC 1020 (1949), acq. 1950-1 Cum. Bull. 3; *Walter R. Stutz,* 10 TCM 506 (1951); *William Collins, Sr.,* 7 TCM 803 (1948); *Jacques Spira,* 7 TCM 371 (1948).

3. ". . . they were not free either to withdraw or transfer their interest. . . ." (Brief 21) This statement is not altogether free from its misleading elements inasmuch as the special partner was not *absolutely* free to withdraw or transfer its interest, but was free to make such withdrawal or transfer with the consent of the general partners (R. 78). It may be noted that no general partner was free to assign his interest except to another partner under any circumstances (ibid.). The Commissioner apparently concedes that restriction on the transferability of a partner's interest is not fatal to the existence of a bona fide partnership, for he quotes with approval (Brief 18) the language of this court in *Toor v. Westover, supra,* to that effect. See also *Joseph Middlebrook, Jr.,* 13 TC 385 (1949), acq. 1950-1 Cum. Bull. 3; *William Collins, Sr., supra.* Nothing in the language of the Supreme Court in *Helvering v. Clifford* would indicate that the donor of all or a part of a special partner's interest in a special partnership *ipso facto* retains powers over the subject matter of the gift sufficient to make him taxable upon the income

thereof. Indeed, in *Nicholas v. Davis, supra,* the capital invested by the limited partners was given them by the general partners with the express understanding that such capital would be invested in the limited partnership; yet, the Court of Appeals for the Tenth Circuit held the partnership to be bona fide for tax purposes.

4. ". . . The taxpayer-settlor, on the other hand, retained complete control over the trust property which he had purportedly given away. . . ." (Brief 21) Here again, the Commissioner confuses the Taxpayer and the special partnership. Far from retaining complete control over the trust property, the Taxpayer divested himself of all interest therein and of all control excepting only such control as he could lawfully exercise in discharge of his duty of absolute good faith to his partners. *Watumull v. Ettinger, supra;* see *Toor v. Westover, supra.* As has been pointed out, retained powers of control over trust property, if they are to render the income therefrom taxable to the donor, must be exercisable by the donor in a non-fiduciary capacity.

5. ". . . He [the Taxpayer] was assured that it would immediately be returned for use in the business which he controlled. . . ." (Brief 21) Assurance that the trust corpus would be invested in a given business appears to be irrelevant under the *Clifford* doctrine unless that business is, in fact, controlled by the Taxpayer. And as has been so often repeated, the business of Edward D. Sultan Co. was controlled

by the Taxpayer only in his capacity as a fiduciary under a duty of absolute good faith to his fellow partners. Indeed, if this and the preceding proposition support the Commissioner's contention, then no transfer in trust wherein the donor named himself trustee could ever be sufficient to shift the incidence of taxation on the income of the transferred property, for in every such case the donor, as donee-trustee, would retain full control of the property (subject, of course, to the terms of the trust instrument) in his fiduciary capacity as trustee.

6. ". . . The partnership which he [the Taxpayer] dominated could also use it in any other business. . . ." (Brief 21-22) As has already been demonstrated, this statement is not in accord with the facts. The partnership was not "dominated" by the Taxpayer except as the general partner having the majority interest therein and, as such, the Taxpayer was bound to discharge a duty of absolute good faith to his fellow partners. Moreover, the partnership could not use the trust property "in any other business" except to the extent that the partnership engaged in another business. And if the partnership engaged in a business other than the wholesale jewelry business, it could do so only on behalf of and for the account of the respective partners, each of whom would share in the fruits of the enterprise in accordance with his capital contribution.

7. ". . . Its [the trust property's] use was to be without restriction by the donee-trust—because the

donee-trust was only a special or limited partner. . . ." (Brief 22) This statement merely recasts the statements numbered 2 and 4, *supra,* and is no more in accord with the facts or law than are those statements.

8. ". . . Its [the trust property's] continued availability was assured because the donee-trust was not free to withdraw or transfer its interest. . . ." (Brief 22) This statement is a mere repetition of the statement numbered 3, *supra.*

9. ". . . The other general partners were the taxpayer's own brothers and sister who also owed their interest to gifts from the taxpayer. . . ." (Brief 22) Although under *Helvering v. Clifford* the close family relationship is relevant, it is by no means controlling and, absent the retained powers of control and disposition emphasized by the Supreme Court, it becomes wholly immaterial. It is perhaps not without significance that the Commissioner does not challenge the status of Taxpayer's brothers and sister as partners in Edward D. Sultan Co.

10. ". . . He [the Taxpayer] could at any time buy out any of the others at book value plus their share of undistributed profits. . . ." (Brief 22) As pointed out above (p. 32), this statement is without support in any of the evidence in the record and is not in accord with the facts.

11. ". . . He [the Taxpayer] could continue the partnership indefinitely and it could likewise be continued by his personal representative upon his death.

. . . " (Brief 22) The power to refrain from exercising the option to terminate the partnership, whether vested in the Taxpayer or, after his death, in his personal representative, would only be relevant if one or more indicia of beneficial control of the trust property in the Taxpayer could be found. As has been demonstrated, however, all of the rights, powers and privileges of the Taxpayer under the trust deed and the special partnership agreement were exercisable by him only as a fiduciary owing a duty of absolute good faith to his fellow partners.

12. ". . . Determinations of the taxpayer, as owner of the majority in interest of the capital contributed by the general partners, were binding upon the partnership and he established the policy of the partnership. . . ." (Brief 22) As has been repeatedly reiterated, any determination by the Taxpayer, as owner of the majority in interest of the capital contributed by the general partners, could lawfully be made only in absolute good faith and in the interests and for the benefit of the partnership. No such determination could lawfully be made by the Taxpayer for his own personal benefit. It is far from uncommon for partnerships, general, special or limited, to utilize managing partners, and the practice has been given express recognition by the courts. *J. A. Riggs Tractor Co.,* 6 TC 889 (1946); *George Brothers & Co.,* 41 BTA 287 (1940).

Clearly, the powers held by the Taxpayer under the trust deed and partnership agreement—and he held very few, if any, of those attributed to him by the Commissioner—do not singly or in the aggregate constitute the "bundle of rights" requisite for the invocation of the doctrine of *Helvering v. Clifford.*

The Commissioner, in his reliance on *Toor v. Westover, supra,* seeks to narrow the holding of this court to a degree unwarranted by the facts and the opinion therein.

That case originated as an action in the District Court for the Southern District of California against a collector of internal revenue to recover sums paid as a result of deficiency assessments of income tax. The case was tried, argued and submitted, and the District Court made and entered its findings of fact. These findings revealed the following situation: Plaintiff made trust agreements with a bank for the benefit of his children, and the trustee of the trusts so created executed articles of limited partnership with plaintiff as the general partner. Under the trust agreements the trustee was restricted to investments either in businesses in which plaintiff was a partner or principal shareholder, or in government bonds. The trust agreements were revocable by the plaintiff as grantor. Plaintiff retained exclusive dominion of the property, the disposition and allocation of the funds derived from the partnership business and all matters requiring judgment or management.

In no instance did the bank use its independent judgment on partnership matters nor did it exercise any of the rights of partnership even by way of advice. The bank, as limited partner, did not exercise dominion and control over the trust corpus in the business nor did it influence the conduct of the partnership or the disposition of the income thereof. The partnership articles conferred on the plaintiff the absolute right to purchase the interest of the limited partner at its book value. There was no business purpose underlying the creation of the partnership, and the District Court commented that the conclusion was warranted that its sole object was to diminish tax liability.

The District Court, applying the *Tower,*[6] *Lusthaus*[7] and *Culbertson*[8] rules, found as a matter of fact that the plaintiff and the trustee-bank did not in good faith intend to join together in the present conduct of the business enterprise (94 F.Supp. 860, 864-66) and entered judgment for defendant.

On appeal to this court, the judgment of the District Court was affirmed in an opinion by Circuit Judge Orr. This court held that the donee trust did not become the substantial owner of a partnership interest which would entitle the partnership to recognition for tax purposes. In reaching that conclusion this court stated that considering the fact that the donee was neither free to remain out of the partner-

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[6] *Commissioner of Int. Rev. v. Tower,* 327 U.S. 280, 90 L.ed 670 (1946).

[7] *Lusthaus v. Commissioner of Int. Rev.,* 327 U.S. 293, 90 L.ed 679 (1946).

[8] *Commissioner v. Culbertson, supra.*

ship nor free to terminate or transfer its interest once the partnership was created, and that the plaintiff, as general manager, retained the powers of management and full discretion as to time and amounts of distribution of profits, the plaintiff remained the substantial owner of the interest he purported to have given away.

In its statement of the case this court recounted substantially all of the facts hereinabove referred to. It quoted the reports of the Senate and House Committees on the Revenue Bill of 1951[9] and in particular the statement that:

> "Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the lights [sic] of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit."

saying of this statement:

> "We believe that this has always been the law." (200 F.2d 713, 716)

Thus it appears that in arriving at its decision in *Toor v. Westover, supra,* this court, while pointing out for the guidance of the lower court the significance of the fact that the donee-trust was neither

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[9]Sen. Rep. No. 781, 82d Cong. 1st Sess. (1951); H. R. Rep. No. 586, 82d Cong. 1st Sess. (1951).

free to remain out of the partnership nor to terminate or transfer its interest once the partnership was created, did not intend to rule that those facts alone and without regard to the other factors present—the revocability of the trust, the plaintiff's exclusive domination of the property and disposition of the funds derived from the partnership, the special partner's completely passive role, and the plaintiff's absolute right to buy out the limited partner at book value—were sufficient in themselves to establish retained substantial ownership in the purported donor.

To adopt the reading of *Toor v. Westover, supra,* contended for by the Commissioner, is to impute to this court a departure from the doctrine of both the *Culbertson* and the *Clifford* cases. The Supreme Court, in the *Culbertson* case, stressed the importance of considering all of the facts in any family partnership case, rather than attempting to apply one or two "objective" tests. And in the *Clifford* case, that court emphasized the cumulative effect of the entire bundle of rights retained by the purported donor, and held that they amounted in the aggregate to substantial ownership.

The Commissioner, however, urges that the holding of this court in the *Toor* case sets up two objective tests in family partnership cases, namely, that in order to be a bona fide partner, recognizable for income tax purposes, a partner must be (1) free to remain out of the partnership and (2) absolutely free to terminate or transfer his interest once the partnership is created. Not only does this reading of the *Toor* case depart from the rationale of the *Culbertson* and *Clifford* cases, but it also tends to bring this court into unnecessary conflict with the Courts of Appeals for the Eighth and Tenth Circuits. *Thompson v. Riggs,* 175 F.2d 81 (8th Cir. 1949); *Nicholas v. Davis,* 204 F.2d 200 (10th Cir. 1953).

Thompson v. Riggs, supra, was an appeal from a judgment for the plaintiff in an action for refund of income taxes. The plaintiff was the owner of a 60% interest in a partnership in which the remaining 40% interest belonged to his son. Plaintiff transferred out of his 60% interest, 5% each to six irrevocable trusts for the benefit of plaintiff's wife and plaintiff's son's family. Plaintiff, his son and a bank were named trustees of each of the trusts. Plaintiff, his son and the trustees then entered into a new partnership agreement.

The trust instruments provided in relevant part that on all matters concerning the management and control of the partnership business, authority to speak for the trustees was vested in plaintiff and his son to the exclusion of the bank, and that the bank was to act as a naked trustee exercising no discretion and being charged with no liability or responsibility for or arising out of the conduct of the partnership business. The trustees could withdraw from the partnership, but any decision as to whether to do so was to be made solely by the plaintiff and his son to the exclusion of the bank. Similarly, the trustees could acquire additional interests in the partnership, but the right to determine whether to do so was vested solely in the plaintiff and his son.

The partnership agreement provided that the management of the partnership business was vested in the plaintiff and his son (and plaintiff's grandson when and if he attained maturity and so long as he retained an interest in the business either as trustee or individually), and further provided that in the event of any disagreement as to the management of the partnership business, the decision of the plaintiff would control so long as he retained an interest in the business individually or as trustee. No partner could assign his interest (except to another partner) without the consent of all of the partners. The trust for the benefit of plaintiff's grandson had an option to purchase the interest of any of the other trusts at net book value.

Since the transfer was of an interest in the partnership and since the right to determine whether any trust should withdraw from the partnership was retained by the plaintiff and his son, the trusts were not free to remain out of the partnership. Since no partner could transfer his interest without the consent of all of the partners (including the plaintiff), none of the trusts was absolutely free to transfer its interest once the partnership was created. Nevertheless, the Court of Appeals, reviewing all of the facts and with the case of *Helvering v. Clifford* having been called to its attention, affirmed the judgment for the plaintiff.

Nicholas v. Davis, supra, concerned three successive partnership, the second of which was a limited partnership. In the second partnership the limited partners were the wives of the general partners. Each general partner gave to his wife certain sums of money from the capital assets of the preceding partnership, with the understanding among all of them that the gifts were to be used for the purchase of limited partners' interests in the second partnership. It appears that the limited partners could neither withdraw nor transfer their interests, since the limited partnership agreement provided that it was to continue for a stated term and that the limited partners would be entitled to the return of their contributions upon the expiration of the term of the partnership, upon the dissolution of the partnership, or upon the consent of all of the other members of the partnership, both general and limited.

The Commissioner assessed a deficiency in income tax against one of the general partners on the thory that the income of his wife as a limited partner was in reality income of that general partner. The general partner concerned brought an action against a collector to recover the amount of the deficiency assessment paid, and the cause was tried before a jury. The plaintiff offered evidence showing, among other things, the facts set out above and the fact that the limited partner enjoyed complete dominion over her distributive share of partnership income, and the collector offered no evidence whatever. By direction of the trial court, a verdict was returned in favor of the plaintiff taxpayer. On appeal from a judgment entered thereon, the Court of Appeals for the Tenth Circuit affirmed the judgment, holding that no question of credibility or issue of fact was presented for determination by a jury.

In each of the foregoing cases the challenged partner was not absolutely free to remain out of the partnership or to terminate or transfer his interest once the partnership was created. On all of the facts in the record, however, those courts held the partnerships concerned to be bona fide recognizable partnerships for income tax purposes.

Given a case in which an examination of all of the evidence leaves doubt as to whether in fact and in law the donor of property has retained such control and dominion thereof as to render him liable for taxes on the income thereof under the doctrine of the *Clifford* case, the addition of the two factors mentioned could properly be sufficient to turn the decision in favor of taxability. It is respectfully submitted that such was the case in *Toor v. Westover, supra,* and that this court, in arriving at its decision in that case, did not base its determination solely upon these two factors, but rather, considering all of the circumstances, found a lack of true ownership in the transferee of the trust property. This rationale is not only borne out by this court's opinion, but also avoids the creation of a conflict of decision between this and the Eighth and Tenth Circuits.

CONCLUSION.

For the reasons set forth, the decisions of the Tax Court are correct and should be affirmed.

Dated, Honolulu, Hawaii,
November 2, 1953.

Respectfully submitted,
MILTON CADES,
Attorney for Respondents.

SMITH, WILD, BEEBE & CADES,
Of Counsel.

(Appendix Follows.)

Appendix.

Appendix

Internal Revenue Code:

Sec. 22. Gross Income

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

Sec. 182. Tax of Partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him——

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 1946 ed., Sec. 182.)

Revised Laws of Hawaii (1935):

Chapter 225. Partnerships, Registration of.

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Part 2. Special

Sec. 6870. *Between individuals.*—A partnership may be formed between two or more individuals for the transaction of any lawful business. A special partnership may be formed between one or more persons, called general partners, and one or more persons called special partners, for the transaction of any business.

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Sec. 6880. *Only general partners act.*—The general partners only shall have authority to transact the business of a special partnership.

Sec. 6881. *Special partners may advise.*—A special partner may at all times investigate the partnership affairs and advise his partners or their agents as to their management.

Sec. 6882. *May loan money. Insolvency.*—A special partner may lend money to the partnership or advance money for it, or to it, and take from it security therefor, and as to such secured loans or advances has the same rights as any other creditor, but in case of the insolvency of the partnership all other claim which he may have against it must be postponed until all other creditors are satisfied.

Sec. 6883. *Receive interest and profits.*—A special partner may receive such lawful interest and such proportion of profits as may be agreed upon, if not paid out of the capital invested in the partnership by him or some other special partner, and is not bound to refund the same to meet subsequent losses.

Sec. 6884. *May not withdraw capital.*—No special partner, under any pretense, may withdraw any part of the capital invested by him in the partnership during its continuance.

Sec. 6885. *Result of withdrawing capital.*—If a special partner withdraws capital from the firm, contrary to the provisions of sections 6883 or 6884, he thereby becomes a general partner.

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LIABILITY OF PARTNERS.

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Sec. 6887. *Of special partners.*—The contribution of a special partner to the capital of the firm, and the increase thereof, is liable for its debts; but he is not otherwise liable therefor, except as follows:

1. If he has wilfully made or permitted a false or materially defective statement in the certificate of the partnership, the affidavit filed therewith, or the published announcement thereof, he is liable as a general partner to all creditors of the firm; or,

2. If he has wilfully interfered with the business of the firm, except as permitted hereinabove, he is liable in like manner; or,

3. If he has wilfully joined in or assented to an act contrary to any of the provisions of sections 6880-6885, he is liable in like manner.

Sec. 6888. *For unintentional act.*—When a special partner has, unintentionally, done any of the acts mentioned in the last section, he is liable, as a general partner, to any creditor of the firm who has been actually misled thereby to his prejudice.